

## Chapter 24

# Reputational Mechanisms in Consumer-to-Consumer Online Commerce

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### ABSTRACT

*The emergence of the internet is similar to the industrial revolution since it fundamentally changed the costs of transmitting information. However, low costs of transmitting information do not address the issue of the quality of information. One area of online commerce where quality of information became a crucial factor to the development and growth of the marketplace was consumer-to-consumer commerce. Asymmetry of information emerged as a detrimental threat to the growth and development of consumer-to-consumer commerce and yet the market found an intuitive and creative way of addressing the issue: feedback and rating mechanisms. Perhaps the greatest example of this is the story of success is the largest consumer-to-consumer platform: eBay.*

### INTRODUCTION

The emergence of the Internet is, in many ways, an historically similar event to the industrial revolution; it has fundamentally changed the cost of transmitting, presenting, and processing information. However, the new means of transmitting and presenting information do not insure its quality. Early in the Internet development, asymmetry of information presented a significant challenge to the adaptation of the Internet in consumer-to-consumer commerce. However, with the help of simple, intuitive, and transparent instruments such as customer review or rating mechanisms, consumer-to-consumer online commerce has been able to overcome this potentially serious obstacle and flourish, changing the way consumers shop.

## **BACKGROUND**

### **Asymmetry of Information**

Asymmetry of information occurs when the parties involved in a transaction have different access to the relevant for the transaction information. The issue of asymmetry of information has been studied by economists for many decades. In 2001, George Akerlof shared the Nobel Prize in economics with Michael Spence and Joseph Stiglitz for their monumental work in the area of asymmetry of information in economics. His groundbreaking work formulated the problem on the example of used car sales, Akerlof (1970). When selling a used car, the seller knows far more about the car than a perspective buyer, putting the buyer into a position of disadvantage. The asymmetrically distributed information not only puts the party with less information at a disadvantage but also creates a disincentive for that party to participate in the transaction. This latter characteristic can threaten the growth and development of an impacted market.

In online consumer-to-consumer commerce, the issue is magnified by the fact that there are two channels for the emergence of asymmetry of information. First, in most cases, the perspective purchasers may not have any direct way of examining the goods they intend to acquire online. Second, historically, buyers have been required to submit payments prior to the seller delivering the item. This dynamic implies that the buyer has to rely on the seller for the accuracy of the item's description and compliance with the terms of transaction.

The success of online consumer-to-consumer marketplaces, including one of the largest such platforms – eBay, serves as an excellent and innovative example of addressing the problem of asymmetry of information. Typically, a consumer-to-consumer website merely serves as the platform for its users to sell/purchase various goods and services. This limited role places the burden of compliance with the terms of transaction on the individual participants and therefore presents the possibility of asymmetry of information.

### **eBay Rating Mechanism**

eBay is perhaps the largest and most recognized consumer-to-consumer website today. eBay is set up as a platform for third party users to sell their goods. eBay corporation merely serves as the marketplace and brokers the trades, but the actual compliance with the terms of transaction is left up to the individual users. By this setup, eBay exposes its users to potentially serious asymmetry of information issues, including the accuracy of item description and compliance with the terms of transaction, such as shipping the product, selecting the correct shipping option, shipping it in a timely fashion, etc. The problem is further highlighted by the customary requirement that the buyer submits the payment prior to the seller shipping the item. Despite the obvious nature of the problem, eBay has become a flourishing consumer-to-consumer platform with the quarterly gross merchandise trade approaching nearly 22 billion dollars in the fourth quarter of 2015 (eBay, 2016).

eBay was able to overcome the asymmetry of information problem by creating a simple and intuitive user rating mechanism. In February of 1996, just six months after the launch of the website, eBay introduced its rating system, back then, referred to as feedback (eBay, 1996). After completing a transaction on eBay, each party can rate the performance of the other along three choices: positive, neutral, and negative. eBay converts these individual responses into a continuous variable, the eBay rating, which

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